BN Higher Rates Imperil Best Gain for Utilities Since 2000: Options
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(For an options column news alert: SALT OMA.)

By Lu Wang

June 27 (Bloomberg) -- For the first time since 2000, utilities are handing investors the best gains in the stock market. Options traders are betting that it won't last.

Power producers have rallied 15 percent this year, the most among the 10 industries in the Standard & Poor's 500 Index. Demand for options that protect against future losses is rising and bearish puts outnumber bullish calls by more than 2-to-1 in an exchange-traded fund tracking companies such as Exelon Corp. and Duke Energy Corp.

Utilities, which offer the fattest dividends after telephone shares and compete with bonds for investors seeking stable yield, will be less attractive as interest rates increase, said Scott Clemons, the chief investment strategist at Brown Brothers Harriman Private Banking. Federal Reserve Bank of St. Louis President James Bullard said yesterday that rates could rise starting in the first quarter of 2015, sooner than most of his colleagues think.

"People are looking at that move and saying, 'That can't be sustained as Fed tapering continues and we get closer and closer to a point at which they actually begin raising interest rates,'" Clemons said in a phone interview from New York June 25. The firm oversees $28 billion.

Rate Outlook

The Federal Open Market Committee is debating how long to keep the benchmark interest rate near zero after completing a bond-purchase program that's set to end late this year. The committee repeated June 18 that it expects rates to remain low for a "considerable time" after the stimulus ends.

Options traders are preparing for potential losses. There are 2.3 puts for every outstanding call on the Utilities Select Sector SPDR Fund, data compiled by Bloomberg show. The ratio reached 3.88 earlier this month, the highest level since 2007.

Eight of the 10 most owned contracts on the utility ETF were bearish. June $42 puts, which had an exercise price 4 percent below yesterday's close, had the largest open interest.

Power producers soared this year with investors seeking safety as the economy contracted in the first quarter and Internet shares plunged. The rally isn't over because the shares' dividend yield is still high and earnings are stable, according to David Kotok, chairman and chief investment officer at Sarasota, Florida-based Cumberland Advisors Inc.

'Getting Respect'

"It's now getting attention, it's getting respect," Kotok, whose firm oversees more than $2 billion of investments, including the utility ETF, said by phone yesterday. "I don't see anything wrong with buying anything that pays me 3.5 percent yield."

The S&P 500 utilities sub-index pays shareholders 3.5 percent, the lowest dividend yield in six years. Profit for companies in the industry will probably increase by about 4 percent through 2016, according to analysts' estimates compiled by Bloomberg.

Now that the economy is starting to pick up, it's not a good time to own these stocks, said John Stephenson, chief executive officer of Stephenson & Co. Capital Management. The Bloomberg Consumer Comfort Index last week held near its highest level this year amid gains in employment and equities.

Buying utilities "is the 'I'm scared, I'm running home to momma trade,'" Stephenson said in a June 23 interview from Toronto. "We're now, in my view, moving into more cyclicals."

Implied Volatility

The cost of hedging against losses in utility shares has risen to levels not seen in more than five years. Implied volatility for the utility fund, a gauge of options prices, was 1.81 points above the SPDR S&P 500 ETF June 19, the most since October 2008, according to data on three-month contracts compiled by Bloomberg.

The Chicago Board Options Exchange Volatility Index, the gauge of S&P 500 options prices known as the VIX, rose 1.3 percent to 11.78 at 10:07 a.m. in New York, within three points of a record low.

Ten-year Treasury yields will finish the year at 3.10 percent, rising from the current 2.53 percent, according to the median economist estimate compiled by Bloomberg. Utilities pay 1.02 percentage points more in dividends.

"You're still in a secular rise in interest rates," David Sowerby, a portfolio manager at Loomis Sayles & Co. in Bloomfield Hills, Michigan, said in a phone interview June 23. The firm oversee about $210 billion. "Historically that's more of a challenge for utilities."

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